Court Decision Illustrates Planning for Payment of Taxes in a Will

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A recent decision in the Ontario Superior Court of Justice illustrates the need for specificity when attempting to allocate tax liability amongst the beneficiaries under a Will. Under Canadian income tax law, there is a deemed disposition of assets owned by a deceased individual immediately before death for notional proceeds equal to fair market value.

The resultant capital gain, if any, is reported and included in income in the deceased's terminal period income tax return. The tax liability is therefore a liability of the deceased or rather his/her estate, and in a sense, all beneficiaries will effectively bear a proportionate share of the cost. Where different beneficiaries are left with separate properties, each of which triggers a deemed capital gain upon the deceased's death and the testator wishes to allocate the tax liability, it is necessary to have an understanding of income tax to properly draw the Will.

The case of *Estate of Andrew Stewart Cromarty* 2011 ONSC 6587 was an application by two named beneficiaries for an order determining the extent of their obligation to pay the capital gains tax owing by the Estate with respect to three farm properties owned by the deceased at the time of his death. Each farm was left to a different beneficiary. Farm #2 was bequeathed to the deceased's niece. Farm #3 was bequeathed to friends of the deceased. Farm #1 fell into residue and a nephew was the residual beneficiary under the Will.

Each farm was a "qualified farm property" and therefore eligible for the lifetime capital gains deduction. There was a deemed capital gain in respect of each of the three properties. The aggregate deemed capital gain for the three farms was in excess of the amount which could be sheltered by the available capital gains deduction.

The Will contained a general provision regarding the payment of taxes. All taxes, including capital gains taxes and probate fees were to be determined as of the date of death and paid from the residue unless otherwise provided in the Will.

In the case of Farm #3, the Will specifically directed that the capital gains taxes "attributable to this property … shall be paid by the beneficiaries of the said property". In the case of Farm #2, the Will stated that the "capital gains tax with respect to this property" was to be paid from the residue. Thus, it seemed that taxes with respect to both Farms #1 and #2 were to be borne by the residue.

The applicants were the beneficiary of Farm #3 and the residual beneficiary. The position of the beneficiary of Farm #3 was essentially that in determining his required payment of capital gains taxes, there should be a pro-rata sharing of the capital gains deduction available to the deceased based upon the relative deemed capital gain of Farm #3 to the aggregate deemed capital gain for the three farms.

The residual beneficiary argued that the measure of taxes properly attributable to Farm #3 was to calculate the difference between the taxes payable with that property included in the calculation and the taxes that would have been payable without that property. This argument would have had the effect of allocating the available capital gains deduction to Farms #1 and #2.

It is trite to state that the obligation of the Court was to ascertain the testator's intention from the language of the Will. In this case, the Court determined that the testator knew that there would be capital gains tax payable at the time of his death. But without "additional or different language", the

Court could only look at the calculation of tax as set out in the T1 general income tax return and the statute. In this regard, the Court found that the calculation of capital gains on Schedule 3 to the T1 is an aggregate calculation for all qualified farm property with the capital gains deduction being applied against the aggregate. As a result, the Court decided in favour of the interpretation advocated by the beneficiary of Farm #3, i.e., pro-rata sharing of the capital gains deduction.

With respect, a capital gain is calculated and reported on a property by property basis. The claim for the capital gains deduction is only an amount and not necessarily allocated on the relevant form to a particular property disposition. However, it would be open to a testator to draft his/her Will to provide for a notional tax calculation on delineated terms and specifically allocate the capital gains deduction, or indeed any other tax benefit (e.g., the effect of marginal income tax rates) for purposes of such calculation. This would avoid the interpretation issue that arose in this case.

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